BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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Order Instituting Investigation to Consider Policies to Achieve the Commission's Conservation Objectives for Class A Water Utilities.	Investigation 07-01-022 (Filed January 11, 2007)
In the Matter of the Application of Golden State Water Company (U 133 W) for Authority to Implement Changes in Ratesetting Mechanisms and Reallocation of Rates.	Application 06-09-006 (Filed September 6, 2006)
Application of California Water Service Company (U 60 W), a California Corporation, requesting an order from the California Public Utilities Commission Authorizing Applicant to Establish a Water Revenue Balancing Account, a Conservation Memorandum Account, and Implement Increasing Block Rates.	Application 06-10-026 (Filed October 23, 2006)
Application of Park Water Company (U 314 W) for Authority to Implement a Water Revenue Adjustment Mechanism, Increasing Block Rate Design and a Conservation Memorandum Account.	Application 06-11-009 (Filed November 20, 2006)
Application of Suburban Water Systems (U 339 W) for Authorization to Implement a Low Income Assistance Program, an Increasing Block Rate Design, and a Water Revenue Adjustment Mechanism.	Application 06-11-010 (Filed November 22, 2006)
Application of San Jose Water Company (U 168 W) for an Order Approving its Proposal to Implement the Objectives of the Water Action Plan.	Application 07-03-019 (Filed March 19, 2007)

REPLY BRIEF – PHASE 1B –
OF CALIFORNIA WATER ASSOCIATION

John K. Hawks
Executive Director
CALIFORNIA WATER ASSOCIATION
601 Van Ness Avenue, Suite 2047
Mail Code #E3-608
San Francisco, CA 94102-3200
Tel: (415) 561-9650
Fax: (415) 561-9652
email: jhawks_cwa@comcast.net

NOSSAMAN, GUTHNER, KNOX & ELLIOTT LLP
Martin A. Mattes
Jose E. Guzman, Jr.
50 California Street, 34th Floor
San Francisco, CA 94111
Tel: (415) 398-3600
Fax: (415) 398-2438
e-mail: jguzman@nossaman.com
Attorneys for CALIFORNIA WATER ASSOCIATION

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REPLY BRIEF – PHASE 1B – OF CALIFORNIA WATER ASSOCIATION

Pursuant to Rule 13.11 of the Commission's Rules of Practice & Procedures and in accordance with the schedule established by ALJ Grau at the last day of evidentiary hearings

on November 27, 2007, California Water Association ("CWA") submits its reply brief in Phase 1B of this proceeding replying to the opening briefs filed January 16, 2007 by the Division of Ratepayer Advocates ("DRA") and the Consumer Federation of California ("CFC"). The following Class A water utility members of CWA join in this reply brief: California American Water Company ("California American Water"), California Water Service Company ("Cal Water"), and Golden State Water Company ("Golden State").

I. INTRODUCTION

Phase 1B of this investigatory proceeding – consolidated with aspects of the water conservation rate design applications of Cal Water, Golden State and Park Water Company ("Park Water") – considers whether the adoption of Water Revenue Adjustment Mechanisms ("WRAMs") and Modified Cost Balancing Accounts ("MCBAs") proposed in settlements of the consolidated applications between each of the foregoing utilities and the Division of Ratepayer Advocates ("DRA")[1] should be accompanied by an immediate reduction in each utility's current, authorized return on equity ("ROE"). DRA recommends an immediate 50 to 100 basis point reduction in the current, authorized ROEs of Cal Water, Golden State and Park Water should the Commission approve the settlement agreements and permit WRAMs and MCBAs to be implemented along with the conservation rate designs proposed in the settlement agreements. However, DRA has failed – in both its showing in the evidentiary hearings and in its opening brief – to prove on any level that a WRAM/MCBA-related ROE reduction is justified.

DRA fails to prove its *theory* that WRAMs and MCBAs unfairly shift sales risk from the utility to the ratepayers, or if there is such a shift in risk, that it has or will have any

[1] The Utility Reform Network ("TURN") is also a party to the settlement agreement between Cal Water and DRA.

impact on a utility's cost of equity capital. Furthermore, DRA has not demonstrated that its recommended immediate, generic 50 to 100 basis point reduction has any reliable basis in finance principles, fact or policy – especially given established Commission policy that rates of return are to be determined on a company-specific basis after consideration of all of the numerous risks faced by an individual utility in the context of a general rate case or cost of capital proceeding. In attempting to meet its burden of proof to justify such an ROE reduction, DRA repeatedly mischaracterizes both the testimony of water utility witnesses and Commission decisions that, it alleges, support such an ROE reduction. DRA also fails to support its contention that an immediate, generic ROE reduction will have no adverse impact on water utilities' access to capital on reasonable terms at a time when access to capital is critically needed for investment in water utility infrastructure.

Like DRA, CFC – which opposes the adoption of WRAMs and MCBAs altogether – also repeatedly mischaracterizes the testimony of water utility witnesses in an attempt to support an ROE reduction. CFC similarly fails to provide any basis in finance principles, fact or policy on which an immediate, generic ROE reduction can be justified in connection with Commission approval of WRAMs and MCBAs for Cal Water, Golden State or Park Water, or any other water utility for whom WRAMs and MCBAs, in conjunction with water conservation rate designs, might be adopted.

CWA discusses all of these points below. However, in the course of focusing on the details of the testimony and other evidence in this proceeding, CWA and its member utilities urge the Commission not to lose sight of the big picture that lies ahead for the delivery of adequate and reliable supplies of safe, high quality drinking water to millions of Californians.

The Commission has wisely embarked upon a mission to pursue water conservation, not as just a temporary policy to address short-term episodes of drought or other water shortage, but as a permanent, ongoing policy and a way of life to which Californians must become accustomed. The Commission's Water Action Plan not only targets water conservation as a key objective but , as essential policies, going forward, the promotion of water infrastructure investment and the adoption of rates that balance the interests of investment, conservation and affordability. Additionally, the Water Action Plan recognizes the nexus between energy and water conservation in stating: **"**Consider energy usage as an important outcome of all water policy decisions and work toward a 10% reduction in energy consumption by the utilities over the next three years.**"** These new policies and objectives portend a fundamental paradigm shift for water utility regulation in California. In this proceeding, the Commission must decide whether isolated, piecemeal, out-of-cycle tinkering with already-authorized utility returns – such as the ROE reduction recommended by DRA – is compatible with this fundamental paradigm shift in regulation. CWA and its member utilities assert that it is not compatible, and that the Commission must send a clear message to all concerned – including the utilities, their customers, and their current and potential investors – that these new policies and objectives will be pursued wholeheartedly and without equivocation.

II. DISCUSSION

A. DRA Fails to Show That Any Shifts in Risk Related to the Adoption of WRAMs and MCBAs Require an Immediate, Generic Reduction in the Returns on Equity of Water Utilities.

DRA contends that WRAMs unfairly shift sales risk from shareholders to ratepayers and expose ratepayers to higher risks, and that therefore a reduction in ROE is

required in order to lower rates and compensate ratepayers for bearing this extra risk.[2] In making this assertion, DRA states that "[p]arties in this proceeding generally agree that the WRAM/MCBA accounting mechanisms will transfer sales-related risk from shareholders to ratepayers, even though they disagree on the magnitude of the risk that is shifted and whether the risk is systematic or unsystematic."[3] However, DRA then proceeds to cite portions of testimony from various water utility witnesses that completely mischaracterize what those witnesses were actually saying. None of those witnesses testified that a shift in sales risk will occur as a result of the WRAMs and all oppose *any* reduction in ROE in connection with the adoption of WRAMs or MCBAs.

For example, DRA cites Golden State's witness, Michael George, as testifying that "[i]mplementation of a WRAM would reduce the potential volatility of utility's revenues resulting from customers' response to conservation incentives."[4] However, Mr. George spoke of the reduction in *potential* volatility of utilities' revenues and did not discuss the transfer of risks from shareholders to ratepayers. He also immediately followed the statement quoted by DRA by referring to "other water utility business risks that are unaffected by implementation of a WRAM … [that] suggest the need for upward adjustment in water utilities' ROE …"[5] Similarly, DRA quotes Park Water's witness, Leigh Jordan, as testifying that WRAMs "would protect Park from two risks, short-term fluctuation in the sales forecast and the effect of conservation on sales."[6] However, Mr. Jordan, like Mr. George, does not discuss any shifting of sales risk from shareholders to ratepayers, and DRA fails to note that immediately following the testimony it quotes, Mr. Jordan goes on to explain that risk mitigation for short-term

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2 DRA Opening Brief, at 7, 13.
3 *Id.*, at 8.
4 *Id.*
5 Prepared Testimony of Michael George ("George Direct Testimony") on behalf of Golden State, October 2007, Hearing Exhibit 31, at 1:14-16.
6 DRA Opening Brief, at 8.

fluctuations in sales forecasting is not significant and that risk mitigation for the effect of conservation on sales "does not result in a decrease in Park's risk; it simply replaces the lost ability to forecast conservation effects and removes the additional sales risk that was imposed … with the adoption [in D.04-06-018] of the New Committee Method [of sales forecasting]."[7] DRA similarly mischaracterizes, by quoting out of context, the testimony of CWA's witness, Susan Abbott, and Cal Water's and Golden State's witness, Walter Hulse, in an attempt to bolster its unfounded assertion that parties in this proceeding "generally agree that the WRAM/MCBA … will transfer sales-related risks from shareholders to ratepayers."[8] There is *no* such agreement, general or otherwise, from the water utilities. Indeed, in its opening brief, CWA described the WRAMs and MCBAs as win-win-win regulatory mechanisms that benefit utilities, ratepayers and the public in general without hurting anyone.[9]

If there is any general agreement in this proceeding about the impact of the WRAMs, it probably is best expressed in provisions contained in each of the settlement agreements between DRA on the one hand, and Cal Water, Golden State and Park Water on the other. For example, Section IX. B., "Recovery and Refund of Balancing Accounts", of the DRA/Golden State settlement agreement provides:

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7 Testimony of Leigh K. Jordan ("Jordan Testimony") on behalf of Park Water, November 17, 2006, Hearing Exhibit 22, at 3-5.

8 DRA cites testimony from CWA's witness, Susan Abbott, that "the WRAM's presumed effect on the reduction in volatility, while mitigating the downside effect of conservation rate design, has the effect of eliminating the potential upside for utility earnings." DRA Opening Brief, at 8, footnote 19. However, Ms. Abbott talks about the *presumed* effect of WRAMs and does not address any shifting of sales risk. DRA also conveniently ignores the very next sentence of Ms. Abbott's testimony that "[a]ccordingly, no adjustment in ROE is necessary or warranted." Direct Testimony of Susan Abbott ("Abbott Direct Testimony") on behalf of CWA, Hearing Exhibit 43, at 12. DRA also cites Cal Water's and Golden State's witness, Walter Hulse, as testifying, with respect to market reaction to the adoption of decoupling mechanisms for natural gas companies, that "[i]n general, research reacts favorably to the implementation of decoupling mechanisms because it eliminates one of the aspects causing volatility in earnings." DRA Opening Brief, at 8. However, again, DRA conveniently ignores the very next sentence in Mr. Hulse's testimony that "this positive reaction has not been shown to translate into a sustained increase in share prices and therefore does not appear to reduce the utility's cost of equity." Direct Testimony of Walter S. Hulse III ("Hulse Direct Testimony") on behalf of Cal Water and Golden State, Hearing Exhibit 45, at 11:2-4.

9 CWA Opening Brief, at 42.

"B. The Parties agree that the desired outcome and purpose of using WRAMs and MCBAs is to ensure that the utility and ratepayers are proportionally affected when conservation rates are implemented.

"1. In the context of this Settlement Agreement, a proportional impact means that, if consumption is over or under the forecast level, the effect on either the utility or ratepayers (as a whole) should reflect that the costs or savings resulting from changes in consumption will be accounted for in a way such that neither the utility or ratepayers are harmed, or benefitted, at the expense of the other party."[10]

Identical provisions are contained in the settlement agreements between DRA and Cal Water, and DRA and Park Water.[11] As the stated intent of DRA and each of the water companies with respect to the WRAMs is that neither party should be harmed or benefitted at the expense of the other party, it is incongruous for DRA to assert that the WRAMs shift sales risk in a manner that reduces the utilities' risk at the expense of ratepayers.

Even if a shift in sales risk would result from adoption of a WRAM, DRA fails to demonstrate that such a shift requires a generic reduction in the existing, authorized returns on equity of Cal Water, Golden State or Park Water. DRA does not distinguish whether the risk theoretically being shifted is systematic (non-diversifiable) risk or unsystematic (diversifiable) risk, despite the extensive testimony of California American Water's witness, Michael Vilbert, and other witnesses on the importance of this distinction. As Dr. Vilbert explained in his direct testimony, it is only systematic risk that affects the expected return investors require in order to provide the utility with equity financing.[12] Therefore, if a reduction in sales risk due to a WRAM were attributable to non-systematic (diversifiable) factors, then it would have no effect on the required rate of return on equity. It then would be incorrect, from an economic standpoint, to claim that a reduction in sales risk reduces the

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[10] Settlement Agreement Between The Division of Ratepayer Advocates and Golden State Water Company on WRAM & Conservation Rate Design Issues, October 19, 2007, at 11.

[11] *See*, Amended Settlement Agreement Between TURN, Cal Water and DRA, June 15, 2007, Section IX. 2), at 10; Settlement Agreement Between DRA and Park Water, June 15, 2007, Section 9.1, at 6.

[12] Direct Testimony of Michael J. Vilbert ("Vilbert Direct Testimony") on behalf of California American Water, October 19, 2007, Hearing Exhibit 33, at 23.

utility's required return on equity without establishing first that the WRAM impacts systematic risk. DRA's witness, Terry Murray, fails to establish that any shift in sales risk resulting from a WRAM is a systematic risk that affects a utility's cost of capital. As explained by Dr. Vilbert in his rebuttal testimony, Ms. Murray simply *assumes* that a WRAM impacts systematic risk, without providing any evidence in support of this assumption.[13]

If a WRAM transfers diversifiable risk from the utility to its ratepayers, then such a transfer does not reduce the compensation investors would require for their investment.[14] As a result, lowering a company's authorized ROE would only serve to negatively impact the utility's ability to attract capital, regardless of whether or not the ratepayers are negatively affected by assuming a diversifiable risk as a result of the WRAM.[15]

DRA incorrectly cites to Dr. Vilbert's testimony for the proposition that the WRAM will shift risk from the utility to its ratepayers. DRA mischaracterizes Dr. Vilbert's testimony, referenced in footnote 38 on page 13 of DRA's opening brief, in which he clearly states that the concern about shifting risk from the utility to ratepayers depends on the type of risk under consideration:

> Before the adoption of the conservation policy, there was a balance of risk among the utility and ratepayers. If adoption of a RAM alters that balance, there should be a debate about the proper allocation of risk between the utility and ratepayers. Before any such policy is adopted, the ramifications should be fully explored. For example, a RAM that is deemed to remove more risk than was created by the conservation policy risks creating inefficiency as a result. *Of course, this concern would not apply to any risk that the utility could not control such as weather-related risk*.[16]

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[13] Rebuttal Testimony of Dr. Michael J. Vilbert ("Vilbert Rebuttal Testimony") on behalf of California American water, November 13, 2007, Hearing Exhibit 34, at 7-8.

[14] CWA Opening Brief, at 9.

[15] *Id.*, at 45-47.

[16] Vilbert Direct Testimony/California American Water, Ex. 33, at 8; emphasis added.

DRA also attempts to rebut the utilities' argument that WRAMs and MCBAs only mitigate the risks imposed by the adoption of conservation rates, thus leaving the utilities with the same level of risk as before implementation of the conservation rates and the WRAMs and MCBAs. DRA asserts that this argument "ignores the reality that WRAMs and MCBAs reduce sales risk from all sources, not just the risk associated with implementing conservation rates." DRA further states that the utilities' argument is "inconsistent" because in the San Jose Water and Suburban cases, where conservation rates will be implemented "without the WRAM/MCBA accounting mechanisms … there is no suggestion that there should be an increase in ROEs of those companies if the settlements are adopted."[17]

However, DRA's attempts to rebut the utilities' argument must fail because, to the extent that the WRAMs and MCBAs reduce sales risk from all sources, not just the risk associated with conservation rates, the arrangement works both ways. That is, the WRAMs and MCBAs protect ratepayers from the risk that actual sales will exceed forecasted sales – regardless of the source of such sales fluctuations. If the utilities end up collecting more revenue than is necessary to cover both their fixed and variable expenses, those "excess" revenues will be returned to ratepayers. Moreover, while San Jose Water and Suburban have not requested increases in their ROEs, this is not because they do not believe that such increases are warranted, but because – as DRA's opening brief notes – "[a]s part of the [San Jose Water and Suburban] settlements, the parties have agreed not to request any ROE adjustments associated with the proposed conservation rate design."[18]

DRA not only recommends a reduction in ROE if WRAMs and MCBAs are adopted for Cal Water, Golden State and Park Water, it recommends that the reduction be

[17] DRA Opening Brief, at 9.
[18] *Id.*, at 4.

implemented immediately. DRA alleges that waiting until these companies' next GRCs "would produce a windfall for the utilities because [Cal Water, Golden State and Park Water] would reap the benefits of shifting sales risk onto ratepayers and ratepayers would receive no compensation for accepting that risk."[19] Putting aside for the moment the spurious allegation of utility windfalls, DRA ignores the fact that the Commission never reduced *authorized* energy utility ROEs in connection with the adoption of revenue adjustment mechanisms. Additionally, the Commission only considered reducing energy utility *requested* ROEs in the context of a GRC or cost of capital proceeding where all other risk factors faced by a utility can be considered.[20] DRA further ignores Commission precedent that utility returns should be determined on a case-by-case basis in GRCs where all of the risks faced by a water utility can be considered in setting an appropriate return on equity. While DRA cites D.06-08-011, a recent decision in a Cal Water GRC, for the proposition that balancing accounts shift risks from utilities to ratepayers, it fails to acknowledge that the Commission in that decision, while agreeing that the effect of a WRAM on rate of return should be examined, cites D.86-05-064, in an investigation into water rate design policy, where it held that:

> "We recognize that a change in rate design affects risk, which in turn impacts a utility's rate of return … Because rate design affects the risk of a utility, we concur that [the impact of rate design on rate of return] should be addressed in future general rate proceedings on a case-by-case basis. *This would enable us to assess the risk associated with a change in rate design with other utility risks so that we can arrive at a reasonable rate of return*."[21]

DRA has failed to show that any theoretical shift in sales risks from utilities to ratepayers as the result of implementing WRAMs and MCBAs involves a shift in systematic risk, which is the only type of risk that impacts a utility's cost of capital. Thus, its case for a

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[19] *Id.*, at 13.
[20] *See*, CWA Opening Brief, at 33-41.
[21] D.06-08-011, *Application of California Water Service Company for an Order Authorizing It to Increase Rates, mimeo*, footnote 18, at 19, citing D.86-05-064; emphasis added.

reduction in existing, authorized ROEs as a result of the adoption of WRAMs and MCBAs also fails. DRA further fails to show why the Commission should make an ROE reduction immediately upon the adoption of WRAMs and MCBAs – something it has never done with respect to the adoption of revenue adjustment mechanisms – instead of following its long-standing policy of evaluating in a GRC or cost of capital proceeding all of the risks faced by a utility in determining an appropriate rate of return for the utility.

B. DRA's Recommended Immediate 50 to 100 Basis Point Reduction in Water Utilities' Return on Equity Has No Basis and Cannot Be Implemented by the Commission.

DRA asserts that its recommended 50 to 100 basis point ROE reduction is "conservative in light of the analysis of DRA's witness that capturing the full shift of risk to ratepayers would likely merit an ROE decrease of much greater magnitude …"[22] CWA contends that DRA's recommendation is not so much conservative; rather, it is completely arbitrary. DRA's contention that that "capturing the full shift of risk to ratepayers" resulting from a WRAM would require a 264 basis point reduction similarly has no basis in fact or finance principles.

CWA discussed at length in its opening brief the serious shortcomings of DRA's analysis of its recommended ROE reduction.[23] DRA's assertions – which are based on its witness's *qualitative* analysis – that "it is reasonable to expect that earnings volatility for … utilities could decrease by 50% or more [as a result of the WRAMs and MCBAs]" and that such a decrease equates to a 264 basis point reduction in ROEs[24] makes absolutely no sense, qualitatively or quantitatively. DRA's math would mean that the entire 528 basis point difference between the risk free 30-year Treasury bond yield (4.88%) and the authorized Cal

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22 DRA Opening Brief, at 10.
23 *See*, CWA Opening Brief, at 8-22, and 24-27.
24 DRA Opening Brief, at 10.

Water ROE (10.16%) is attributable solely to earnings volatility. In other words, DRA asserts that the *only* risk faced by the water utilities is earnings volatility. This simply ignores all of the significant risks about which numerous witnesses in this proceeding testified, including water quality risk, water supply risk, and regulatory risk.

DRA attempts to bolster this untenable position by stating that its 50% reduction in earnings volatility "is consistent with the reports of financial analysts such as *Value Line*, A.G. Edwards and Janney Research …"[25] However none of those analysts' reports referenced in Ms. Murray's testimony mentions any specific percentage reduction in earnings volatility that might result from the adoption of WRAMs and MCBAs. Nor do the analysts' reports state that earnings volatility is the sole risk faced by water utilities.

With respect to DRA's recommended 50 to 100 basis point reduction in ROE, Ms. Murray testified that there was no way mathematically to get from 264 basis points to 50 – 100 basis points. Instead, her recommendation apparently is based on her qualitative analysis.[26] But even that qualitative analysis is undercut by DRA's and Ms. Murray's acknowledgement of "the pioneering nature of [the WRAMs and MCBAs] *and the inherent uncertainty about their effect* …"[27]

DRA also attempts to justify its recommended ROE reduction by citing two GRC cases in which it recommended significant ROE reductions in connection with the adoption of WRAMs.[28] While DRA prominently mentions its recommendations, only in footnotes does it admit that the Commission rejected its recommended ROE reductions in both

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[25] *Id.*

[26] Reporter's Transcript ("RT"), at 929:13-26 (Murray/DRA).

[27] DRA Opening Brief, at 12; emphasis added. Despite DRA's admission that there is an "inherent uncertainty about the effect" of the WRAMs and MCBAs, DRA asserts that not reducing the utilities' ROE "would produce a *windfall* for the utilities because [the utilities] would *reap the benefits* of shifting sales risk onto ratepayers …" *Id.*, at 13; emphasis added. Given the inherent uncertainty about the effect of the WRAMs and MCBAs, such an assertion is very difficult to accept.

[28] *Id.*, at 11.

cases. In the first case, a Cal Water GRC, the Commission decision called DRA's recommended 300 basis point reduction "arbitrary".[29] Regarding the second case, a California American Water GRC, DRA's opening brief notes a proposed ALJ decision in that case which, DRA alleges, "engaged in an extensive analysis and would have implemented an ROE reduction of 50 basis points." In addition to the fact that DRA's description of California American Water's proposed Full Cost Balancing Account in inaccurate,[30] the proposed ALJ decision in that proceeding has no relevance whatsoever since the Commission refused to adopt that portion of it.[31] Moreover, CWA disputes that it contained an "extensive analysis" of the ROE reduction issue.

There simply is no reliable basis on which the Commission can accept DRA's arbitrary 50 to 100 basis point ROE reduction recommendation. Any impact on an individual water utility's risk from the adoption of a WRAM and MCBA must be considered together with all of the other risk factors faced by the utility. The appropriate venue for doing that is the upcoming cost of capital proceedings, not this proceeding.

C. A WRAM-Related Reduction in Return on Equity Will Adversely Affect Water Utilities' Access to Capital at a Time When Access to Capital Is a Critical Need.

DRA asserts that its proposed ROE reduction recognizes the impact of an ROE adjustment on access to capital markets and the long-term financial stability of the utilities.

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[29] *See*, D.06-08-011, *supra, mimeo*, at 18.

[30] DRA Opening Brief, footnote 35, at 11. DRA confuses the Full Cost Balancing Account proposed by California American Water in its Los Angeles General Rate Case with the Modified Cost Balancing Account at issue here. *See* Rebuttal Testimony of David P. Stephenson on Rate Design Issues on behalf of California American Water Company, September 29, 2006, Hearing Exhibit 55 in A.06-01-005 (In the Matter of the Application of California-American Water Company (U210W) for an order authorizing it to increase its rates for water service in its Los Angeles District to increase revenues by $2,020,466 or 10.88% in the year 2007; $634,659 or 3.08% in the year 2008; and $666,422 or 3.14% in the year 2009), at 17-21 (discussing the Full Cost Balancing Account proposed by California American Water).

[31] *See*, D.07-08-038, *In the Matter of the Application of California-American Water Company for an Order Authorizing it to Increase Rates,* 2007 Cal. PUC LEXIS 444 (2007), at *3.

Stating that it "recognizes that ratepayers have a strong interest in the long-term stability of the water utilities, and that water infrastructure needs significant invest … DRA recommends an ROE reduction of *only* 50 – 100 basis points …"[32]

CWA disputes that DRA's recommended ROE reduction recognizes the impact on the water utilities' access to capital markets and their long-term financial stability. If this were true, DRA would be recommending no reduction or, more appropriately, an increase in ROEs. A 100 basis point reduction is not small. For most, if not all Class A water utilities, such a reduction would take their ROEs below double digits, further exacerbating the inequitable spread between energy and water utilities' authorized ROEs and breaking through an important psychological floor for investors. As CWA's witness, Susan Abbott testified, "rating agencies and many fixed-income investors who really got hurt at certain points in history through investments in California have eloquent memories."[33] At a time when perceptions of an improving regulatory environment in California are finally coming to the fore, the Commission must not take a step backward.

DRA states that a "decrease in earnings volatility that will result from [the WRAMs and MCBAs] is likely to be attractive to an investor and beneficial to the utility." But instead of leaving it at that, DRA recommends a reduction in existing, authorized ROEs that will eliminate whatever benefit the introduction of WRAMs and MCBAs might have in improving the financial well-being of the utilities. Instead of advocating policies that will help to achieve the Commission's objective of promoting water infrastructure investment, DRA is recommending a "let's see how much pain the water utilities can take before the financial community notices" approach. This is a dangerous and ill-advised game of brinksmanship

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[32] DRA Opening Brief., at 12; emphasis added.
[33] RT, 1076:23 – 1077:17 (Abbott/CWA).

whose only likely outcomes will be the restriction of the utilities' access to investment capital and corresponding harm to ratepayers. As CWA's witness, Ms. Abbott, testified, "[a]ny attempt to maintain and improve credit quality [of the water utilities] would be adversely affected by a diminution in allowed returns on equity. Such an action would be sorely misguided, and would negatively impact the water utilities' ability to attract capital at reasonable rates and on a when needed basis."[34]

There is no disagreement that substantial investment in water infrastructure is currently required and will continue to be required in order for the water utilities to meet their obligations of providing adequate and reliable supplies of safe, high quality drinking water to the public. The Commission must do all that it can to promote such investment. Any WRAM-related reduction in existing, authorized ROEs would be contrary to that objective.

D. The Consumer Federation of California Seriously Mischaracterizes Water Utility Witnesses' Testimony in a Failed Attempt to Support a WRAM-Related Reduction in Return on Equity.

The Consumer Federation of California opposes the adoption of WRAMs and MCBAs as proposed in the Cal Water, Golden State and Park Water settlement agreements with DRA. However, it recommends that if WRAMs and MCBAs are adopted by the Commission, the ROE reduction proposed by DRA should be implemented.[35]

CFC's opposition to the adoption of the WRAMs and MCBAs appears to be based on a fundamental misunderstanding of the purpose of conservation rates, WRAMs and MCBAs. CFC starts out by describing a WRAM as "a piecemeal adjustment to previously approved rates, to reduce the risk the water companies will not earn their allowed revenue."[36]

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[34] Abbot Direct Testimony/CWA, Ex. 43, at 13.
[35] CFC Opening Brief, at 1.
[36] *Id.*

CFC also alleges that the WRAMs would constitute a piecemeal adjustment to test year costs.[37] Of course, neither statement is true. The conservation rate designs provided for in the settlement agreements are not piecemeal adjustments to previously approved rates. Rather, they are entirely new rates aimed at promoting water conservation. Similarly, neither the new inverted block rates, nor the WRAMs and MCBAs propose any change to previously forecasted and adopted costs. The new conservation rates are designed to recover the costs previously forecasted and adopted in the utilities' last general rate cases.

CWA is less concerned with CFC's opposition to the approval of the settlement agreements than it is with CFC's support for a reduction in the utilities' ROEs should the WRAMs and MCBAs be implemented. Like DRA, in its attempts to support an ROE reduction, CFC seriously mischaracterizes the testimony of a number of the water utilities' witnesses' testimony. The Commission should not tolerate such blatant misrepresentations.

For example, CFC mischaracterizes the testimony of CWA's witness, Susan Abbott, on a number of different issues. Referring to DRA's claims that WRAMs will shift risk from utilities to ratepayers thereby changing the balance of risk and reward, and that if you don't change the ROE, ratepayers will be harmed, CFC asserts that Ms. Abbott agrees with DRA's witness and quotes Ms. Abbott as testifying that an ROE adjustment, when coupled with the WRAM, "puts you in the same place you started."[38] The assertion that Ms. Abbott agrees with Ms. Murray is totally false. CFC's quote of Ms. Abbott's testimony is taken completely out of context. In the paragraph of Ms. Abbott's testimony quoted by CFC, Ms. Abbott was describing the theoretical argument that if you implement a beneficial policy (the WRAM) and at the same time reduce ROE, it puts you in the same place with respect to overall

[37] *Id.*, at 6-7.
[38] *Id.*, at 10.

risk where you started, assuming the existing single block rates are not changed at the same time to increasing block rates. However, CFC ignores the very next paragraph of Ms. Abbott's testimony:

> "*The reality of the situation* [however] … is that if you look at the way the rating agencies and ergo the investment community, [*i.e.*] fixed income investment community has regarded adjustment clauses in California in particular, they have not given a lot of credit, if any, whatsoever in terms of a diminution in risk in that the electric utilities have been dealing with these adjustment clauses for decades [and] are considered to be riskier than your average utility.[39]

Again, on page 12 of CFC's opening brief, CFC mischaracterizes Ms. Abbott's testimony in a very misleading way regarding the improved regulation in California and regarding the credit ratings of the California water utilities. CFC cites Ms. Abbott's testimony that capital may become scarce due to regulatory risk, but then asserts that that will not be a problem based on Ms. Abbott's testimony that "a number of prominent watchers of regulation have made comments about California regulation being improved." This is a gross mischaracterization of Ms. Abbott's testimony. The testimony quoted by CFC was Ms. Abbott's testimony in response to one of Commissioner Bohn's question about why Ms. Abbott believes regulatory risk in California is such a large risk to water utilities when Commissioner Bohn hears comments about California regulation being improved. Ms. Abbott was acknowledging that she had heard the same comments, but she was not stating her agreement with those observations. Indeed, she went on to say that the perception of improved regulation has not made a difference in the investment community because "rating agencies and many fixed-income investors who really got hurt at certain points in history through investments in California have eloquent memories."[40] With respect to Ms. Abbott's testimony that, based on the financial metrics used by the rating agencies, the Class A water utility members of CWA

[39] RT, at 1039:15-23 (Abbott/CWA).
[40] RT, 1076:14-1077:16 (Abbott/CWA).

would have a single-A rating, CFC completely ignores Ms. Abbott's qualification that the single-A rating might apply "assuming their business risk is assessed at "3". Ms. Abbott then goes on to discuss a number of significant risk factors faced by the water utilities that make a business risk assessment of "3" highly unlikely.[41]

CFC also mischaracterizes the testimony of Golden State's witness, Michael George. CFC claims that "[a]ccording to Mr. George, it is unlikely that ratepayers will see any savings from their water conservation efforts."[42] A quick look at the cited testimony reveals that CFC misstates Mr. George's testimony and takes it out of context. First, Mr. George did *not* testify that it is *unlikely* that ratepayers will see any savings, but agreed with a statement in comments by Golden State to the Draft Water Action Plan that there was a possibility that ratepayers *may* not see any savings from their conservation efforts and become frustrated. More importantly, the original statement with which he agreed was specifically limited to periods when there is high capital investment.[43] This makes sense because during periods of high capital investment, any savings resulting from conservation may not translate into lower bills because of the impact on costs of offsetting capital expenditures. When read in context, Mr. George's testimony provides no support for CFC's blanket and unsupported statement that the combined WRAM/MCBA is likely to *increase* customer bills.[44]

CFC also argues that a chilling effect on the utilities' ability to attract capital is unlikely to result from a reduction in ROE.[45] To support its argument, CFC claims that Mr. George recognizes that "utility stocks may look like a good investment" in the immediate

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41 Abbott Direct Testimony, Ex. 43, at 9-10.
42 CFC Opening Brief, at 9.
43 *See*, RT, 843:17-28 (George/Golden State).
44 CFC Opening Brief, at 9.
45 *Id.*, at 11.

future. Mr. George's testimony[46] was in response to a hypothetical and made no mention of a particular time period, much less the "immediate future." Nor did Mr. George indicate that the capital market was volatile "now" or would be volatile "in the immediate future." After noting that the hypothetical question posed was too general, Mr. George simply agreed that as a general proposition, during a recession and when interest rates fall, utility stocks look like a better investment than CDs and bonds.[47] As he explained, this is because during periods of high volatility rational investors tend to look for quality – *i.e.*, reduced risk but with reduced returns – rather than the possibility of greater returns with higher risk, in order to reduce their overall exposure to risk.[48] However, the hypothetical assumptions that all investors always make rational decisions or that they may consider water utility equities a safer or preferable investment during a volatile market is not *evidence* that a reduction to a utility's ROE will not have negative impact on its ability to attract capital.

CFC also mischaracterizes the testimony of California American Water's witness, Michael Vilbert. On page 9 of CFC's opening brief, CFC quotes Dr. Vilbert's testimony regarding fuel cost past-throughs used by natural gas utilities and how they impose the risk of fuel cost increases on ratepayers. CFC wrongly equates such fuel cost pass-throughs with WRAMs and cites Dr. Vilbert's testimony as evidence that the WRAMs shift risks to ratepayers. However, Dr. Vilbert's testimony provided, in a general context, an example of *one* of many factors that would affect the balance of risks borne by utilities and ratepayers. Contrary to CFC's contention, the WRAM is *not* primarily concerned with purchased power

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[46] Mr. George testified "[t]hat in periods of volatility when there is a flight to quality, utility equities tend to be viewed as less volatile and therefore tend to benefit from a flight to quality." RT, 842: 26-843:1 (George/Golden State Water).

[47] RT, 842:16-26 (George/Golden State).

[48] RT 842:26-843:16 (George/Golden State).

cost pass-throughs.[49] As Dr. Vilbert testified in his direct testimony, assessing the impact on the return on equity "one risk at a time" is poor regulatory policy because it is impossible to estimate the individual effect of a single policy adjustment on the required rate of return on equity with sufficient accuracy.[50] Indeed, the adoption of conservation measures together with the introduction of a WRAM can have more than one effect on the sources of risk facing a water utility.[51]

Similarly, the comparison suggested by the CFC between Dr. Vilbert's opinion in a certain Pennsylvania electricity rate case and the present case is misplaced. As demonstrated by Dr. Vilbert, his recommendation in that case was based upon unique circumstances that are irrelevant here.[52] In summary, in the Pennsylvania case a rate cap was in place that prevented the utility from being able to recover fully its purchased power costs when these costs exceeded the cap, but only recovered the actual purchased power costs when they were low.[53] As a result, the utility faced asymmetric risk, because it would pass the benefits of low costs onto consumers, while carrying the burden of high costs itself. In such an environment, as Dr. Vilbert explained in his direct testimony,[54] the utility would not expect to earn its cost of capital on average. The 18.2% ROE adjustment was derived as a way of restoring the utility's opportunity to earn its cost of capital, and not as a compensation for ordinary cost of capital risk. In particular, the Pennsylvania utility's cost of capital did not change.[55] What changed was the allowed return necessary to provide the utility a fair opportunity to earn its cost of capital when the utility faced asymmetric risk. This was

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49 Vilbert Direct Testimony/California American Water, at 3-5.
50 *Id.*, at 27-28.
51 *Id.*, at 28.
52 RT, 855 (Vilbert/California American Water).
53 RT, 855:19-24 (Vilbert/California American Water).
54 Vilbert Direct Testimony/California American Water, at 13-15.
55 RT, 856:2-9 (Vilbert/California American Water).

evidenced by the fact that Dr. Vilbert recommended, as mentioned in the hearing in this case and in agreement with his direct testimony in the present case,[56] eliminating the source of asymmetric risk rather than compensating for it through an increase in the allowed ROE.[57]

Because CFC provides no support for the actions it urges, while also so badly mischaracterizing the testimony of the water utilities' witnesses, the Commission should give little, if any, weight to CFC's opening brief.

E. The Commission Must Not Lose Sight of Three Important Objectives Expressed in the Water Action Plan – Water Conservation, Infrastructure Investment, and Rates That Balance Investment, Conservation and Affordability – By Implementing an ROE Reduction That Discourages All Three.

As noted at the outset of this reply brief, the Commission's Water Action Plan includes among its six key objectives for water utility regulation the strengthening of water conservation programs to a level comparable to those of energy utilities, the promotion of infrastructure investment, and the setting of rates that balance investment, conservation and affordability. The Commission must not lose sight of these ultimate objectives and must do everything within its powers to achieve them. Among the actions specified for achieving the strengthening of water conservation programs are the removal of financial disincentives to water conservation and the establishment of financial *incentives* for greater conservation. Among the actions specified for achieving the setting of rates that balance investment, conservation and affordability are the setting of rates which provide sufficient revenue to promote adequate investment in infrastructure and the development of innovative policies to develop sources of funding needed for adequate infrastructure.

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[56] Vilbert Direct testimony/California American Water, at 15.
[57] RT, 856 (Vilbert/California American Water).

Reducing the existing, authorized ROEs of Cal Water, Golden State and Park Water in connection with the implementation of WRAMs and MCBAs is contrary to these objectives and to the actions specified by the Commission for achieving them. WRAMs are designed to remove the financial disincentives for promoting water conservation. A WRAM-related ROE reduction would impose a financial penalty on water utilities, discouraging their promotion of water conservation and unduly handicapping their efforts to achieve this key objective. In short, an ROE reduction is the complete antithesis of a financial incentive for greater conservation. A WRAM-related ROE reduction also sends a dangerous signal to the investment community that utilities will be penalized, not rewarded for their water conservation efforts. It is likely to discourage any enthusiasm for investment in California water utilities. A WRAM-related ROE reduction also is contrary to the goal of setting rates that provide sufficient revenues to promote adequate investment in infrastructure. Indeed, a WRAM-related ROE reduction is the polar opposite of innovative policies to develop sources of funding needed for adequate infrastructure.

In short, ordering a WRAM-related ROE reduction of any amount would be a misguided action that would seriously hamper achievement of the Commission's Water Action Plan objectives.

III. CONCLUSION

As demonstrated in CWA's opening brief and in this reply brief, a generic reduction to existing, authorized returns on equity of any amount for Cal Water, Golden State and Park Water in connection with the adoption of the water revenue adjustment mechanisms and modified cost balancing accounts proposed in settlement agreements with DRA is neither warranted nor justified, and should not be ordered. Returns on equity should be established on a company-by-company basis in upcoming cost of capital proceedings where all of the specific

risks faced by an individual water utility can be evaluated together in determining an appropriate return for that company.

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Respectfully submitted,

NOSSAMAN, GUTHNER, KNOX & ELLIOTT LLP
Martin A. Mattes
Jose E. Guzman, Jr.

By */S/ JOSE E. GUZMAN, JR.*

50 California Street, 34th Floor
San Francisco, CA 94111
Tel: (415) 398-3600
Fax: (415) 398-2438
e-mail: jguzman@nossaman.com

Attorneys for CALIFORNIA WATER ASSOCIATION

John K. Hawks
Executive Director
CALIFORNIA WATER ASSOCIATION
601 Van Ness Avenue, Suite 2047
Mail Code #E3-608
San Francisco, CA 94102-3200
Tel: (415) 561-9650
Fax: (415) 561-9652
email: jhawks_cwa@comcast.net

CERTIFICATE OF SERVICE

I, Jeannie Wong, hereby certify that on this date I will serve by electronic mail or hand delivery the foregoing REPLY BRIEF – PHASE 1B – OF CALIFORNIA WATER ASSOCIATION, on all parties on the attached CPUC service list for I.07-01-022:

By electronic mail:

charak@nclc.org; jlkiddoo@swidlaw.com; owein@nclcdc.org; ataketa@fulbright.com; tkim@rwglaw.com; debershoff@fulbright.com; fyanney@fulbright.com; ed@parkwater.com; leigh@parkwater.com; rdiprimio@valencia.com; bobkelly@bobkelly.com; dadellosa@sgvwater.com; tjryan@sgvwater.com; rkmoore@gswater.com; kswitzer@gswater.com; nancitran@gswater.com; kendall.macVey@bbklaw.com; cmailloux@turn.org; jhawks_cwa@comcast.net; marcel@turn.org; nsuetake@turn.org; mpo@cpuc.ca.gov; mlm@cpuc.ca.gov; ndw@cpuc.ca.gov; enriqueg@lif.org; jguzman@nossaman.com; lweiss@steefel.com; Ldolqueist@steefel.com; sleeper@steefel.com; mmattes@nossaman.com; lex@consumercal.org; pucservice@dralegal.org; pucservice@dralegal.org; dstephen@amwater.com; pschmiege@schmiegelaw.com; sferraro@calwater.com; lmcghee@calwater.com; broeder@greatoakswater.com; palle_jensen@sjwater.com; bill@jbsenergy.com; jeff@jbsenergy.com; demorse@omsoft.com; darlene.clark@amwater.com; danielle.burt@bingham.com; john.greive@lightyear.net; mcegelski@firstcomm.com; charles.forst@360.net; doug@parkwater.com; luhintz2@verizon.net; dietrichlaw2@earthlink.net; debbie@ejcw.org; tsmegal@calwater.com; bloehr@greatoakswater.com; tguster@greatoakswater.com; chris@cuwcc.org; katie@cuwcc.org; mvander@pcl.org; bdp@cpuc.ca.gov; dsb@cpuc.ca.gov; trh@cpuc.ca.gov; flc@cpuc.ca.gov; jcp@cpuc.ca.gov; jlg@cpuc.ca.gov; jws@cpuc.ca.gov; llk@cpuc.ca.gov; lwa@cpuc.ca.gov; phh@cpuc.ca.gov; smw@cpuc.ca.gov; tfo@cpuc.ca.gov

By Hand Delivery:

Hon. Janice L. Grau
Administrative Law Judge
California Public Utilities Commission
505 Van Ness Avenue, Room 5011
San Francisco, CA 94102

Executed this 6th day of February, 2008 in San Francisco, California.

/S/ JEANNIE WONG
Jeannie Wong

CALIFORNIA PUBLIC UTILITIES COMMISSION

Service Lists

PROCEEDING: I0701022 - CPUC - CLASS A WATER
FILER: CPUC - CLASS A WATER COMPANIES
LIST NAME: LIST
LAST CHANGED: JANUARY 25, 2008

Parties

CHARLIE HARAK
NATIONAL CONSUMER LAW CENTER
77 SUMMER STREET, 10TH FLOOR
BOSTON, MA 02110-1006
FOR: NATIONAL CONSUMER LAW CENTER

JEAN L. KIDDOO
ATTORNEY AT LAW
BINGHAM MCCUTCHEN LLP
3000 K STREET, N.W. SUITE 300
WASHINGTON, DC 20007
FOR: FIRST COMMUNICATIONS, INC.LIGHTYEAR NETWORK SOLUTIONS, LLC,AND XTENSION SERVICES,INC.

OLIVIA B. WEIN
ATTORNEY AT LAW
NATIONAL CONSUMER LAW CENTER
1001 CONNECTICUT AVE., NW., STE. 510
WASHINGTON, DC 20036
FOR: NATIONAL CONSUMER LAW CENTER

ALLYSON TAKETA
ATTORNEY AT LAW
FULBRIGHT & JAWORSKI, LLP
555 SO. FLOWER STREET, 41ST FLOOR
LOS ANGELES, CA 90071
FOR: GOLDEN STATE WATER COMPANY

B. TILDEN KIM
ATTORNEY AT LAW
RICHARDS WATSON & GERSHON
355 SOUTH GRAND AVENUE, 40TH FLOOR
LOS ANGELES, CA 90071
FOR: CITY OF NORWALK

DAVID A. EBERSHOFF
ATTORNEY AT LAW
FULBRIGHT & JAWORSKI, L.L.P.
555 SO. FLOWER STREET, 41ST FLOOR
LOS ANGELES, CA 90071
FOR: PARK WATER

FRED G. YANNEY
ATTORNEY AT LAW
FULBRIGHT & JAWORSKI, LLP
555 SOUTH FLOWER STREET
LOS ANGELES, CA 90071
FOR: GOLDEN STATE WATER COMPANY

EDWARD N. JACKSON
DIR. OF REVENU REQ., PARK WATER CO
PO BOX 7002
9750 WASHBURN ROAD
DOWNEY, CA 90241-7002
FOR: PARK WATER COMPANY

LEIGH K. JORDAN
SENIOR VP
APPLE VALLEY RANCHOS WATER COMPANY
PO BOX 7002, 9750 WASHBURN RD.
DOWNEY, CA 90241-7002
FOR: APPLE VALLEY RANCHOS WATER COMPANY

ROBERT J. DIPRIMIO
VALENCIA WATER COMPANY
24631 AVENUE ROCKEFELLER
VALENCIA, CA 91355

ROBERT KELLY
SUBURBAN WATER SYSTEMS
1211 EAST CENTER COURT DRIVE
COVINA, CA 91724-3603

DANIEL A. DELL'OSA
SAN GABRIEL VALLEY WATER COMPANY
11142 GARVEY AVENUE
EL MONTE, CA 91734
FOR: SAN GABRIEL VALLEY WATER CO

MICHAEL L. WHITEHEAD
SAN GABRIEL VALLEY WATER CO.
PO BOX 6010
EL MONTE, CA 91734

TIMOTHY J. RYAN
ATTORNEY AT LAW
SAN GABRIEL VALLEY WATER COMPANY
11142 GARVEY AVENUE, PO BOX 6010
EL MONTE, CA 91734
FOR: SAN GABRIEL VALLEY WATER CO

RONALD MOORE
SOUTHERN CALIFORNIA WATER COMPANY
630 EAST FOOTHILL BLVD.
SAN DIMAS, CA 91773

KEITH SWITZER
VP REGULATORY AFFAIRS
GOLDEN STATE WATER COMPANY
630 EAST FOOTHILL BLVD.
SAN DIMAS, CA 91773-9016
FOR: GOLDEN STATE WATER COMPANY

NANCI TRAN
GOLDEN STATE WATER
630 E. FOOTHILL BLVD.
SAN DIMAS, CA 91773-9016
FOR: GOLDEN STATE WATER

KENDALL H. MACVEY, ESQ.
ATTORNEY AT LAW
BEST, BEST & KRIEGER, LLP
3750 UNIVERSITY AVENUE, SUITE 300
RIVERSIDE, CA 92501
FOR: CITY OF CLAREMONT

CHRISTINE MAILLOUX
ATTORNEY AT LAW
THE UTILITY REFORM NETWORK
711 VAN NESS AVENUE, NO. 350
SAN FRANCISCO, CA 94102
FOR: TURN

JACK HAWKS
CALIFORNIA WATER ASSOCIATION
601 VAN NESS AVE., SUITE 2047
SAN FRANCISCO, CA 94102

MARCEL HAWIGER
ATTORNEY AT LAW
THE UTILITY REFORM NETWORK
711 VAN NESS AVENUE, SUITE 350
SAN FRANCISCO, CA 94102
FOR: THE UTILITY REFORM NETWORK

NINA SUETAKE
ATTORNEY AT LAW
THE UTILITY REFORM NETWORK
711 VAN NESS AVE., STE. 350
SAN FRANCISCO, CA 94102

MARCELO POIRIER
CALIF PUBLIC UTILITIES COMMISSION
LEGAL DIVISION
ROOM 5025
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214
FOR: DRA

MONICA L. MCCRARY
CALIF PUBLIC UTILITIES COMMISSION
LEGAL DIVISION
ROOM 5134
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214
FOR: DRA

NATALIE WALES
CALIF PUBLIC UTILITIES COMMISSION
LEGAL DIVISION
ROOM 4107
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214
FOR: DRA

ENRIQUE GALLARDO
LATINO ISSUES FORUM
160 PINE STREET, SUITE 700
SAN FRANCISCO, CA 94111
FOR: LATINO ISSUES FORUM

JOSE E. GUZMAN, JR.
ATTORNEY AT LAW
NOSSAMAN, GUTHNER, KNOX & ELLIOTT, LLP
50 CALIFORNIA STREET, 34TH FLOOR
SAN FRANCISCO, CA 94111
FOR: CALIFORNIA WATER ASSOCIATION

LENARD G. WEISS
ATTORNEY AT LAW
STEEFEL, LEVITT & WEISS, P.C.
ONE EMBARCADERO CENTER, 30TH FLOOR
SAN FRANCISCO, CA 94111
FOR: CALIFORNIA-AMERICAN WATER/SWS

LORI ANN DOLQUEIST
ATTORNEY AT LAW
STEEFEL, LEVITT & WEISS
ONE EMBARCADERO CENTER, 30TH FLOOR
SAN FRANCISCO, CA 94111
FOR: SUBURBAN WATER SYSTEM COMPANY

SARAH E. LEEPER
ATTORNEY AT LAW
STEEFEL LEVITT & WEISS PC
1 EMBARCADERO CENTER 30TH FLOOR
SAN FRANCISCO, CA 94111
FOR: CALIFORNIA-AMERICAN WATER

MARTIN A. MATTES
ATTORNEY AT LAW
NOSSAMAN, GUTHNER, KNOX & ELLIOTT, LLP
50 CALIFORNIA STREET, 34TH FLOOR
SAN FRANCISCO, CA 94111-4799
FOR: CALIFORNIA WATER ASSN.

ALEXIS K. WODTKE
STAFF ATTORNEY
CONSUMER FEDERATION OF CALIFORNIA
520 S. EL CAMINO REAL, STE. 340
SAN MATEO, CA 94402
FOR: CONSUMER FEDERATION OF CALIF

LISA BURGER
DISABILITY RIGHTS ADVOCATES
2001 CENTER STREET, 3RD FLOOR
BERKELEY, CA 94704
FOR: DISABILITY RIGHTS ADVOCATES

MELISSA W. KASNITZ
ATTORNEY AT LAW
DISABILITY RIGHTS ADVOCATES
2001 CENTER STREET, THIRD FLOOR
BERKELEY, CA 94704-1204
FOR: DISABILITY RIGHTS ADVOCATES

DAVID P. STEPHENSON
CALIFORNIA-AMERICAN WATER COMPANY
4701 BELOIT DRIVE
SACRAMENTO, CA 94838

PATRICIA A. SCHMIEGE
ATTORNEY AT LAW
LAW OFFICE OF PATRICIA A. SCHMIEGE
705 MISSION AVENUE SUITE 200
SAN RAFAEL, CA 94901
FOR: SAN JOSE WATER COMPANY

FRANCIS S. FERRARO
VICE PRESIDENT
CALIFORNIA WATER SERVICE COMPANY
1720 NORTH FIRST STREET
SAN JOSE, CA 95112
FOR: CALIFORNIA WATER SERVICE COMPANY

LYNNE P. MCGHEE
ATTORNEY AT LAW
CALIFORNIA WATER SERVICE COMPANY
1720 NORTH FIRST STREET
SAN JOSE, CA 95112

BETTY R. ROEDER
PRESIDENT
GREAT OAKS WATER COMPANY
15 GREAT OAKS BLVD., SUITE 100
SAN JOSE, CA 95119

PALLE JENSEN
DIRECTOR, REGULATORY AFFAIRS
SAN JOSE WATER COMPANY
374 WEST SANTA CLARA ST.
SAN JOSE, CA 95196

BILL MARCUS
JBS ENERGY
311 D STREET, STE. A
WEST SACRAMENTO, CA 95605
FOR: TURN

JEFFREY NAHIGIAN
JBS ENERGY, INC.
311 D STREET
WEST SACRAMENTO, CA 95605

DAVID MORSE
CALIFORNIA WATER SERVICE COMPANY
1411 W. COVELL BLVD., STE. 106 - 292
DAVIS, CA 95616-5934
FOR: CALWATER

DARLENE M. CLARK, ESQ.
CORPORATE COUNSEL
CALIFORNIA AMERICAN WATER
4701 BELOIT DRIVE
SACRAMENTO, CA 95838-2434
FOR: CALIFORNIA AMERICAN WATER CO

Information Only

DANIELLE C. BURT
BINGHAM MCCUTCHEN LLP
3000 K STREET, NW, SUITE 300
WASHINGTON, DC 20007-5116
FOR: FIRST COMMUNICATIONS,LLC,LIGHTYEAR NETWORK SOLUTIONS, LLC,XTENSION SERVICES, INC.

JOHN GREIVE
LIGHTYEAR NETWORK SOLUTIONS, LLC
1901 EASTPOINT PARKWAY
LOUISVILLE, KY 40223

MARY CEGELSKI
FIRST COMMUNICATIONS, LLC
15166 NEO PARKWAY
GARFIELD HEIGHTS, OH 44128

CHARLES FORST
360NETWORKS(USA) INC.
867 COAL CREEK CIRCLE/SUITE 160
LOUISVILLE, CO 80027

DOUGLAS K. MARTINET
PARK WATER COMPANY
PO BOX 7002
DOWNEY, CA 90241

DONALD R. WARD
ORCUTT AREA ADVISORY GROUP, INC.
4689 MARLENE DRIVE
SANTA MARIA, CA 93455

WILLIAM F. DIETRICH
ATTORNEY AT LAW
DIETRICH LAW
2977 YGNACIO VALLEY ROAD, 613
WALNUT CREEK, CA 94598-3535

DEBBIE DAVIS
LEGISATIVE ANALYST
ENVIRON JUSTICE COALITION FOR WATER
654 13TH STREET
PRESERVATION PARK, CA 94612

THOMAS F. SMEGAL
MANAGER OF RATES
CALIFORNIA WATER SERVICE COMPANY
1720 NORTH FIRST STREET
SAN JOSE, CA 95112

ROBERT A. LOEHR
ATTORNEY AT LAW
GREAT OAKS WATER COMPANY
15 GREAT OAKS BLVD., SUITE 100
SAN JOSE, CA 95119
FOR: GREAT OAKS WATER COMPANY

TIMOTHY S. GUSTER
GENERAL COUNSEL
GREAT OAKS WATER COMPANY
PO BOX 23490
SAN JOSE, CA 95153

ADRIAN HANSON
1231 FORRESTVILLE AVENUE
SAN JOSE, CA 95510

CHRIS BROWN
EXECUTIVE DIRECTOR
CALIFORNIA URBAN WATER CONSERVATION
455 CAPITOL MALL, SUITE 703
SACRAMENTO, CA 95814

KATIE SHULTE JOUNG
CALIFORNIA URBAN WATER CONSERVATION
455 CAPITOL MALL, SUITE 703
SACRAMENTO, CA 95814

MATT VANDER SLUIS
PLANNING AND CONSERVATION LEAGUE
1107 9TH STREET, SUITE 360
SACRAMENTO, CA 95814

State Service

BERTRAM D. PATRICK
CALIF PUBLIC UTILITIES COMMISSION
DIVISION OF ADMINISTRATIVE LAW JUDGES
ROOM 5110
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

DIANA BROOKS
CALIF PUBLIC UTILITIES COMMISSION
WATER BRANCH
ROOM 4208
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214
FOR: DRA

EDWARD HOWARD
CALIF PUBLIC UTILITIES COMMISSION
POLICY & PLANNING DIVISION
ROOM 5119
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

FRED L. CURRY
CALIF PUBLIC UTILITIES COMMISSION
WATER AND SEWER ADVISORY BRANCH
ROOM 3106
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

JAEYEON PARK
CALIF PUBLIC UTILITIES COMMISSION
WATER BRANCH
ROOM 4208
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

JANICE L. GRAU
CALIF PUBLIC UTILITIES COMMISSION
DIV OF ADMINISTRATIVE LAW JUDGES
ROOM 5011
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

JOYCE STEINGASS
CALIF PUBLIC UTILITIES COMMISSION
WATER BRANCH
ROOM 4208
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

LAURA L. KRANNAWITTER
CALIF PUBLIC UTILITIES COMMISSION
EXECUTIVE DIVISION
ROOM 5303
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

LISA WALLING
CALIF PUBLIC UTILITIES COMMISSION
WATER BRANCH
ROOM 4208
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

PATRICK HOGLUND
CALIF PUBLIC UTILITIES COMMISSION
WATER BRANCH
ROOM 4208
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

SEAN WILSON
CALIF PUBLIC UTILITIES COMMISSION
UTILITY AUDIT, FINANCE & COMPLIANCE BRAN
AREA 3-C
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

TATIANA OLEA
CALIF PUBLIC UTILITIES COMMISSION
WATER BRANCH
ROOM 4104
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214
FOR: DRA